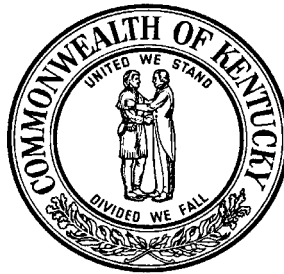


**LETTER FROM THE AUDITOR OF PUBLIC ACCOUNTS
KENTUCKY DEPARTMENT OF REVENUE**

**In Reference to the Statewide Single Audit
of the Commonwealth of Kentucky**

**For the Year Ended
June 30, 2005**



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TABLE OF CONTENTS

MANAGEMENT LETTER.....	1
LIST OF ABBREVIATIONS/ACRONYMS.....	3
FINANCIAL STATEMENT FINDINGS	4
<i>Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance</i>	<i>4</i>
FINDING 05-REV-1: Electronic Payments To The Clearing Account Are Not Accurately Posted In Revenue's System, And No Corrections Of Those Errors Are Being Made.....	4
FINDING 05-REV-2: The Department Of Revenue Should Ensure That All Penalties Are Distinctively Reported Into The Revenue's System	6
FINDING 05-REV-3: The Department Of Revenue Should Strengthen Physical Securities.....	8
<i>Other Matters Relating to Internal Controls and/or Instances of Noncompliance</i>	<i>10</i>
FINDING 05-REV-4: The Department Of Revenue Should Establish Written Balancing Procedures For The Sales & Use Tax System.....	10
FINDING 05-REV-5: The Department Of Revenue Should Ensure That All Open Ports On Agency Machines Have A Business-Related Purpose	11
FINDING 05-REV-6: The Department Of Revenue Should Ensure That All Agency Web Servers Have Updated Software And Security Patches Installed	12
FINDING 05-REV-7: Computer Systems Should Be Updated To Remove System Limitations.....	14
FINDING 05-REV-8: Motor Fuels Dealer Reports Should Be Crosschecked For Accuracy To Ensure All Taxes Have Been Remitted	15
FINDING 05-REV-9: The Department Of Revenue Should Consistently Process Local Distribution Journal Vouchers.....	18
FINDING 05-REV-10: The Department Of Revenue Should Ensure The Late Transfers Of Motor Vehicle Usage Tax Are Being Thoroughly Tracked Or Penalized.....	20
FINDING 05-REV-11: Motor Fuel Dealer Reports Should Be Processed Properly	23
FINDING 05-REV-12: The Department Of Revenue Should Maintain Tax Returns In A Manner That Ensures Compliance With Confidentiality And Record Retention Laws And Ensures Accountability To Kentucky Taxpayers.....	24
FINDING 05-REV-13: The Department Of Revenue Should Determine The Reason An Unhonored Check Processed Incorrectly And Fix The Problem.....	26
FINDING 05-REV-14: The Department Of Revenue Should Strengthen Controls With The Compliance And Receivable System	27
FINDING 05-REV-15: The Department Of Revenue Should Ensure Proper Cash Handling Procedures Are Being Followed	28
FINDING 05-REV-16: The Department Of Revenue Should Deposit Unidentified Payments More Timely.....	30
SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS.....	32



CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

To the People of Kentucky
Honorable Ernie Fletcher, Governor
John Farris, Secretary, Finance and Administration Cabinet
Department of Revenue

MANAGEMENT LETTER

KRS 43.090 (1) requires the Auditor of Public Accounts, upon completion of each audit and investigation, to prepare a report of all findings and recommendations, and to furnish copies of the report to the head of the agency to which the report pertains, and to the Governor, among others. This KRS also requires the Department of Revenue to, within 60 days of the completion of the final audit, notify the Legislative Research Commission and the Auditor of Public Accounts of the audit recommendations it has implemented and those it has not implemented and any reasons therefore. We are providing this letter to the Department of Revenue in compliance with KRS 43.090.

The work completed on the Department of Revenue is part of the overall opinions included in the audit of the Commonwealth of Kentucky's Comprehensive Annual Financial Report (CAFR) and Statewide Single Audit of Kentucky (SSWAK). Findings and recommendations for agencies, audited as part of the CAFR and SSWAK, if applicable, can be found in the Statewide Single Audit Report. This report can be obtained on our website at www.auditor.ky.gov.

In planning and performing our audits of the Commonwealth for the year ended June 30, 2005, we considered the Department of Revenue's internal control over financial reporting and compliance with laws, regulations, contracts and grant agreements in order to determine our auditing procedures for the purpose of expressing opinions included in the audit of the CAFR and SSWAK and not to provide an opinion on internal control or on compliance.

However, during our audit we became aware of certain matters that are opportunities for strengthening internal controls and operating efficiency. The SSWAK is a separate report dated March 9, 2006 and contains all reportable conditions and material weaknesses in the Commonwealth's internal control structure and also contains all reportable instances of noncompliance. This letter does contain the Department of Revenue's findings and our recommendations that have been extracted from the SSWAK report along with other matters that have been identified.



To the People of Kentucky
Honorable Ernie Fletcher, Governor
John Farris, Secretary, Finance and Administration Cabinet
Department of Revenue

We will review the status of these comments during our next audit. We have already discussed many of these comments and suggestions with various Department of Revenue personnel, and we will be pleased to discuss them in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations.

Included in this letter are the following:

- ◆ Acronym List
- ◆ Findings and Recommendations
- ◆ Summary Schedule of Prior Year Audit Findings

Respectfully submitted,



Crit Luallen
Auditor of Public Accounts

Audit fieldwork completed -
March 9, 2006



LIST OF ABBREVIATIONS/ACRONYMS

ACH	Automated Clearinghouse
APB	Accounting Principles Board
CARS	Compliance And Receivable System
CAFR	Comprehensive Annual Financial Report
CD	Compact Disk
Commonwealth	Commonwealth of Kentucky
COT	Commonwealth Office of Technology
C1E	Electronic Payment
DOR	Department of Revenue
EFT	Electronic Funds Transfer
FAC	Finance and Administration Cabinet
FASB	Financial Accounting Standards Board
Finance	Finance and Administration Cabinet
FY	Fiscal Year
FYE	Fiscal Year End
GAAP	Generally Accepted Accounting Principles
HTTP	Hyper Text Transfer Protocol
JV	Journal Voucher
KRS	Kentucky Revised Statutes
MARS	Management Administrative Reporting System
MIXERS	Miscellaneous Taxes Registration System
MVU	Motor Vehicle Usage
OSBD	Office of the State Budget Director
RCW	Record of Control Weakness
REV	Department of Revenue
Revenue	Department of Revenue
RFP	Request For Proposals
SSWAK	Statewide Single Audit of Kentucky

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 05-REV-1: Electronic Payments To The Clearing Account Are Not Accurately Posted In Revenue's System, And No Corrections Of Those Errors Are Being Made**

The Department of Revenue maintains detailed records for each taxpayer, while tax receipts are summarized in MARS. To ensure that data in both systems is reliable, Revenue performs a monthly reconciliation of receipts by tax type between its figures and those in MARS. During testing of this process, we found that thirty-one (31) of the thirty-seven (37) reconciling items at the end of FY05 were errors in the processing of electronic payments to the clearing account (Fund 1400, R000). These errors were identified in the monthly reconciliation process by Revenue Division of Operations staff, but no corrections were made. Examination of four (4) interim reconciliations revealed that every error related to an electronic payment (C1E document) was carried forward as a reconciling item for the rest of year, while other types of errors were corrected.

Revenue personnel are able to determine the date and amount of the discrepancies, but not the reason. Finance personnel note that no other agency using the e-pay system has a problem with discrepancies; this fact strongly suggests that the problem's source is the report that Revenue uses to post. Detailed data from the vendor is being accurately summarized for entry into MARS, but the complete information for posting to taxpayer accounts in Revenue's system is not always being accurately transmitted.

For FY05 the net dollar impact was immaterial (only \$11,771) because some of the differences were positive and others were negative. However, as long as these errors are not being corrected, the possibility remains for their impact to become material in future years. The complete absence of a process to correct recurring errors or resolve their cause reveals a control weakness.

Revenue's posting of electronic payments to the clearing account does not always match the amount actually deposited into Farmers Bank and posted in MARS. This becomes apparent when each month's reconciliation is performed. The payment and reconciliation processes are described below.

The E-pay process: Every workday, Link to Gov (a vendor that handles credit and debit card transactions for several state agencies) sends a file to Finance containing details of the electronic receipts that it will deposit into Farmers Bank the next day. Finance performs several processing steps, including the creation of C1E documents to describe and post the transactions in MARS. This posting consists of totals for each agency (including Revenue) by tax type. The C1E document data must match the data in the file from Link to Gov. MARS processes the C1E documents with the rest of the nightly run. The next day Revenue's Division of Operations personnel pull a report on the transaction and use it to post the receipts to Revenue's system. Revenue's posting is more detailed than the one in MARS, because Revenue must credit each separate taxpayer account.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 05-REV-1: Electronic Payments To The Clearing Account Are Not
Accurately Posted In Revenue's System, And No Corrections Of Those Errors Are
Being Made (Continued)**

The reconciliation process: Revenue Division of Operations staff members perform a monthly reconciliation of receipts for each tax type by comparing Revenue's system figures to those in MARS. Certain tax types are reported but not adjusted because Revenue does not post to them. Each discrepancy in the other tax types is researched and its source identified. If the discrepancy is the result of a timing difference, there is no need for action. However, when the discrepancy between Revenue and MARS is the result of an error, Revenue is supposed to prepare and execute journal vouchers to correct the error.

None of the discrepancies resulting from electronic payments to the clearing account were corrected during FY05. When discrepancies are not corrected in a timely manner, the accuracy and reliability of the Revenue reporting system is in question.

Good internal controls dictate that errors should be corrected in a timely manner after they are identified. Furthermore, the cause of recurring errors should be identified and corrected.

Recommendation

We acknowledge that Revenue has begun to address the problem. An August 10, 2005 meeting of personnel from Revenue, Finance, and COT resulted in a plan of action that included tracing the data processed for several days to try to find the location and cause of errors. A request has been filed for COT to review the report Revenue uses for posting.

For now Revenue should:

- Establish a method to make corrections until the system is fixed.
- Confirm daily totals with Finance to try to prevent discrepancies in posting.
- Continue its efforts to identify the source of the discrepancy, including scrutinizing the report now used as the source of data for posting.
- Explore linking its computer system to MARS in a way that eliminates the need for reconciliations and duplicate entries.

Management's Response and Corrective Action Plan

The Department of Revenue (DOR) agrees with the auditor's recommendations that a method must be established to provide the information necessary to correct errors found during the reconciliation process for payments made through the Epay

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 05-REV-1: Electronic Payments To The Clearing Account Are Not
Accurately Posted In Revenue's System, And No Corrections Of Those Errors Are
Being Made (Continued)**

Management's Response and Corrective Action Plan (Continued)

system. DOR has been aware of the inconsistency, as a result of its own reconciliation process, and has been working on implementing a corrective process prior to this finding. DOR is in the process of researching the use of "smart codes" to send with all files that would follow the transaction through the process and come back to DOR when verification of payment is received back from Farmer's Bank. These smart codes would include specific tax account numbers, case numbers, or notice numbers to differentiate each payment. This would allow DOR to verify each specific e-payment transaction received back paid by Farmer's Bank before the associated transaction is processed to DOR databases. This information would then be available during the reconciliation process and allow DOR to make the necessary adjustments when errors are detected.

Significant progress has been made in addressing the systems problems associated with the reconciliation process. The server stability issue which resulted in payment posting errors has been resolved. Additionally, a system report provides a listing of duplicate payments prior to posting. The duplicate payment is then manually removed prior to posting. COT is conducting system integration testing to determine needs and means to further refine the process.

**FINDING 05-REV-2: The Department Of Revenue Should Ensure That All Penalties
Are Distinctively Reported Into The Revenue's System**

The Department of Revenue's system does not post penalties that are declared on tax returns. During the testing of tax returns we noted the tax amount posted in the system did not match the amount shown on one (1) return. The system posting did not agree to the return amount because penalties declared do not post to Revenue's system.

This is a system weakness that creates the risk that Revenue will not record, bill, or receive all penalties due. Penalties do post to another Revenue system for billing, but not to this Revenue system when the return is filed. This does pose a risk with the multiple options for filing returns.

When penalties declared are not entered into Revenue's system, the system will treat the account as paid in full if the total amount of tax due is paid. There is a risk that the penalty will not be collected.

The Department of Revenue has a responsibility to collect tax and penalties in as complete and equitable a manner as feasible so that all taxpayers are treated in an equitable manner.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 05-REV-2: The Department Of Revenue Should Ensure That All Penalties
Are Distinctively Reported Into The Revenue's System (Continued)**

KRS 131.030 describes the functions of the Department of Revenue, in subsection (1) stating in part that:

The Department of Revenue shall exercise all administrative functions of the state in relation to the state revenue and tax laws, ... the equalization of tax assessments, ... and the enforcement of revenue and tax laws....

Good internal controls dictate that each transaction should be recorded in its entirety.

Recommendation

The Department of Revenue should modify its system to assure that the collection of penalties is the same for every means of filing. All relevant information contained in the Forms should be entered into the system. Penalties reported with the filing should be distinctly coded within the system, assuring that failure to pay the penalty would not go unnoticed.

Management's Response and Corrective Action Plan

Some penalties are billed separately from other tax and penalties because of rules and exceptions that must be communicated to the taxpayer. The return record generates the penalty billing if the return meets the Department of Revenue's criteria. Any penalty that is billed will post to the history screen only if the penalty is paid. The payment regardless of the method of filing returns should post to the DOR system as penalty identified from other penalties by a unique code. If the penalty is withdrawn, voided, or charged off, there is not a record of the billing on the history screen.

DOR agrees with the RCW regarding the issue of the penalty amount that was being recorded as tax when paid. This concern is being addressed in the system changes this year. It has always been DOR's intent to post the monies separately. However, from a practical standpoint, getting the money in the bank and not generating erroneous billings has taken priority.

FINANCIAL STATEMENT FINDINGS

Reportable Conditions Relating to Internal Controls and/or Reportable Instances of Noncompliance

FINDING 05-REV-3: The Department Of Revenue Should Strengthen Physical Securities

Physical security at a Department of Revenue facility is inadequate.

Images from the security surveillance cameras are not properly stored. The security surveillance cameras are recording, but the images from the camera are not being transferred to a CD for file maintenance. Only a limited number of days of recording are available on the cameras for reviewing. The equipment that was purchased by Revenue has the capability to record an extended period of security recordings onto a CD. Due to system incapability the digital images from the security surveillance cameras are not being recorded onto a CD at all.

Vault security is lax. The key to the vault is accessible to anyone who works in the building. Approximately 100 people use the key on a daily basis. A vault access log is maintained, but only required for staff that works outside of the facility. Without proper monitoring procedures of the vault, the department is susceptible to theft or unauthorized entry.

The facility recently switched from a VHS recording system to a digital image recording system. Images from a digital recording system produce a clearer picture. The existing system could be used to identify a theft only if the theft were discovered within a limited number of days. This severely hampers the system's usefulness.

Poor physical security controls and procedures expose an agency to unnecessary risk. Failure to take proper precautions to secure the department's assets leaves the department susceptible to the possibility of theft, unauthorized entry, damage to property, financial loss, legal repercussions, or loss of credibility.

Good internal controls dictate that proper precautions be taken to safeguard assets from loss, damage, or misappropriation. Strong internal controls are essential to protect the department's assets.

Recommendation

We recommend that the Department of Revenue identify the source of the system incompatibility of the digital imaging equipment and implement a corrective action plan that results in long-term storage of security camera images.

The Department of Revenue should also strengthen their internal controls by maintaining a log of all users of the vault key, or have the interior door equipped with a swipe badge lock requiring individuals to use his or her badge to gain entrance.

FINANCIAL STATEMENT FINDINGS***Reportable Conditions Relating to Internal Controls and/or
Reportable Instances of Noncompliance*****FINDING 05-REV-3: The Department Of Revenue Should Strengthen Physical
Securities (Continued)**

Management's Response and Corrective Action Plan

DOR agrees with the Auditor's finding in this RCW. DOR is pursuing options with regard to long-term storage of video images. Changes to recording equipment have improved the length of record time possible. Offsite storage of images is also being considered.

DOR has investigated the possibility of installing a camera inside the vault, however, the vault is constructed of concrete all around so drilling to install a camera would diminish the structural integrity of the vault. There is a camera at the door of the vault that records continuously. Therefore, the DOR does not intend to pursue this option at this time. However, other options related to the vault key are being considered by DOR.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 05-REV-4: The Department Of Revenue Should Establish Written Balancing Procedures For The Sales & Use Tax System**

The Department of Revenue, Systems Support Branch (Branch) did not develop formalized procedures for the balancing process of the Sales and Use Tax System.

The Branch obtains Sales and Use Tax reports monthly and the control totals are balanced to ensure that the tax return totals balance with the posted and deposited receipts. Though there were no formal procedures documented we did note that during our testing of the Sales and Use Tax system, the Branch staff did perform the monthly reconciliations and the same individual employee had been performing these reconciliations during the last five (5) years.

The Sales and Use Tax balancing procedures are complicated and without formalized balancing procedures, there is no assurance that all steps have been completed to reconcile all tax payments to the monthly processed receipt totals. Further, other employees cannot easily be trained to perform all balancing procedures accurately for this system.

Formalized system balancing procedures illustrate management's concern for strong controls within the system. Ultimately, the Production Support Branch is responsible for the supporting documentation and should ensure the completeness and accuracy of balancing procedures for the Sales and Use Tax system. Formalized procedures help ensure consistent balancing of the system processes as support that all returns and receipts were accurately and completely processed.

Recommendation

We recommend the Department of Revenue develop detailed written procedures to be followed for the monthly balancing and reconciliation process for the Sales and Use Tax. These procedures should include a listing of all reporting documents required to perform the balancing accurately and a description of error resolution processes for any errors discovered during the balancing process. Further, the formal procedures should be made available to any employee responsible for Sales and Use Tax system balancing tasks.

Management's Response and Corrective Action Plan

The Department agrees with the Auditor's findings and written procedures for the monthly balancing procedure will be in place by the next audit.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-REV-5: The Department Of Revenue Should Ensure That All Open Ports On Agency Machines Have A Business-Related Purpose

During the FY 2005 security vulnerability assessments performed for machines owned by the Department of Revenue (Revenue), our examination revealed web service vulnerabilities present on four (4) machines. These vulnerabilities could be exploited to compromise and possibly gain administrative control of these machines. The vulnerabilities found on three (3) machines included HTTP methods of OPTIONS, TRACE, COPY, PROPFIND, SEARCH, LOCK and UNLOCK, which can be abused in many cases. Unauthorized use of these commands can reveal sensitive system information or provide methods to misuse the services and files the site provides.

Further, the auditor noted vti_bin executables on one (1) machine that could provide information about server settings and/or reveal the physical path of the server components. One (1) additional machine has an outdated Apache Web service running and could provide too much information to a potentially unauthorized user. A remote attacker could be allowed to initiate a denial of service (process crash) and possibly execute arbitrary code, allowing a large amount of data to be copied.

The vulnerabilities identified appear to result from outdated or unpatched software. These vulnerabilities could possibly allow an attacker from a remote location to execute arbitrary code and gain administrative control of the agency's systems or to force a denial of services.

To maintain adequate security it is necessary to ensure all required web services are appropriately updated and all applicable security patches have been installed.

Though these machines may be physically located within the Commonwealth's Office of Technology (COT) and managed by COT, Revenue management is ultimately responsible for the security of Revenue resources.

Recommendation

We recommend that Revenue coordinate with COT the necessary actions to properly secure these machines to ensure that web services on each identified machine are appropriately updated or patched, and take other security measures as needed to eliminate the specified web service vulnerabilities.

Management's Response and Corrective Action Plan

"In response to your ongoing assessment of the security governing Commonwealth computer systems, we have investigated the vulnerabilities identified in your FY 2005 formal comments to the Department of Revenue. The information provided under separate cover will explain the results of our investigation and the determined risk status for each item. We believe that network security is essential to secure limited resources and we appreciate your continued diligence

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-REV-5: The Department Of Revenue Should Ensure That All Open Ports On Agency Machines Have A Business-Related Purpose (Continued)

Management's Response and Corrective Action Plan (Continued)

and assistance in assuring that the computer systems for the Department of Revenue are properly secured.

All the findings noted during the interim vulnerability assessment testing of machines within the Department of Revenue have been examined. The Department of Revenue recognizes the importance of security."

Auditor's Reply

The agency's response included detailed information for each machine the auditor reported on, indicating that some ports and web services that may have associated vulnerabilities are necessary. It is the agency's discretion to determine an acceptable level of risk. As seen within the detail the agency did this on a number of occasions. Otherwise, the agency has taken measures to eliminate risk on specific machines.

FINDING 05-REV-6: The Department Of Revenue Should Ensure That All Agency Web Servers Have Updated Software And Security Patches Installed

During the security vulnerability assessments for FY 2005 for machines controlled by the Department for Revenue (Revenue), our examination revealed that there were several machines with ports open that may not have a specific business-related purpose. We examined the open ports on 26 machines returning information during our scans. These findings are grouped below by port number.

Port 80 - HTTP

Twenty-four (24) machines were found to have port 80 open. Nineteen (19) of the machines displayed no legitimate web page and one (1) machine was under construction and does not currently display a default page. Three (3) of the machines provided web access to printer devices and one (1) machine provided excessive information concerning the device status by listing a configuration summary.

When no default website page or login request is present, normally this means that no application/web service is running and the port is not needed. More significant is the invitation this open port provides to any unauthorized user.

Port 443 - Hypertext Transfer Protocol over Secure Socket Layer (HTTPS/SSL)

Seven (7) machines were found with port 443 open that did not appear to have an application/web service running on them. Port 443 is a default port for HTTPS/SSL, which is the encrypted form of HTTP that normally runs over port 80 by an e-commerce site. When no default page or restricted logon is required, normally this means that no application/web service is running at this port.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-REV-6: The Department of Revenue Should Ensure That All Agency Web Servers Have Updated Software and Security Patches Installed (Continued)

The existence of unused open ports increases potential security vulnerabilities and is an invitation for intruders to enter the system. System configuration information would be intriguing to a hacker and should be restricted.

To minimize the risk of unauthorized access to a machine, only necessary, business-related ports should be open. Information concerning system configuration should not be made publicly available.

Recommendation

We recommend that Revenue review all open ports to ensure there is a specific business-related purpose requiring the port to be open. If not required, then that port should be closed. If the port is necessary then Revenue should ensure the most recent patches are implemented for the service in use and that adequate logical security controls are implemented to prevent unauthorized access as necessary.

Management's Response and Corrective Action Plan

"In response to your ongoing assessment of the security governing Commonwealth computer systems, we have investigated the vulnerabilities identified in your FY 2005 formal comments to the Department of Revenue. The information provided under separate cover will explain the results of our investigation and the determined risk status for each item. We believe that network security is essential to secure limited resources and we appreciate your continued diligence and assistance in assuring that the computer systems for the Department of Revenue are properly secured.

All the findings noted during the interim vulnerability assessment testing of machines within the Department of Revenue have been examined. The Department of Revenue recognizes the importance of security."

Auditor's Reply

The agency's response included detailed information for each machine the auditor reported on, indicating that some ports and web services that may have associated vulnerabilities are necessary. It is the agency's discretion to determine an acceptable level of risk. As seen within the detail the agency did this on a number of occasions. Otherwise, the agency has taken measures to eliminate risk on specific machines.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-REV-7: Computer Systems Should Be Updated To Remove System Limitations

Revenue's Sales Tax Database does not process payments of \$1,000,000 or more in a single transaction. Instead, these transactions appear in the database as a series of \$999,999.99 payments with a final balancing payment amount to arrive at the transaction total. As a result, there is not a one-to-one match of database entries to payments. Making multiple entries creates more opportunities for data entry errors.

This system limitation resulted in two (2) accelerated payments during FY01 that overstated receipts in Revenue's mainframe system by \$7.5 million. While audit tests have found no errors in subsequent fiscal years (including FY05), the recording process that caused the errors in FY01 has not been corrected, so the potential remains for revenues to be incorrectly recorded in the future.

We recognize that Revenue is developing a new Sales and Use Tax System in connection with Kentucky's participation in the multi-state Streamlined Sales and Use Tax Agreement. Cutover is scheduled to begin in October 2005, but completion before the end of FY06 is doubtful.

Although the financial statement information in FY05 was not affected, the system limitation could impair the accuracy and reliability of the Revenue reporting system. When tax information is not captured exactly as reported on the tax return, both the difficulty of recording receipts for the proper amount and the likelihood of failing to detect entry errors are increased.

Good internal controls dictate that all receipts post accurately to Revenue's Sales Tax Database from supporting documentation, regardless of the receipt amount. Each transaction should be posted exactly as it was received.

Recommendation

We recommend Revenue complete and implement the new Sales and Use Tax System as currently planned, which will meet the requirements of the multi-state Streamlined Sales and Use Tax Agreement and establish the capacity to record large payments in a single transaction.

Management's Response and Corrective Action Plan

Revenue agrees that updating the mainframe system to accommodate payment transactions greater than \$1,000,000 would provide more concise, accurate, and efficient information for end users. During FY 2004, work progressed on the replacement system for the Sales and Use Tax system, including mapping of the current system and business requirements for the new system. During FY 05, a replacement system to correct current design limitations was expected to be

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 05-REV-7: Computer Systems Should Be Updated To Remove System Limitations (Continued)**

Management's Response and Corrective Action Plan (Continued)

realized. However, in FY 05 the new system was divided into 3 phases and a total replacement was delayed pending a RFP that will be let in early 2006 for a possible comprehensive tax system. A new comprehensive system will ultimately accommodate all design improvements anticipated with the previous replacement of the sales and use tax system. In the meantime, internal controls are currently in place to continually monitor the sales tax database, particularly the accelerated filers program.

Procedures are in place and being followed to accommodate the accelerated returns until the replacement system becomes fully operational. A select number of experienced and trained employees are dedicated to working the accelerated returns with direct supervision and internal controls to ensure proper oversight in the current environment. Until the new system is fully operational, management will strive to ensure the accuracy and reliability of the reporting system. While the current system may be difficult to interpret, payment transactions are represented in the system in their entirety.

FINDING 05-REV-8: Motor Fuels Dealer Reports Should Be Crosschecked For Accuracy To Ensure All Taxes Have Been Remitted

Revenue's motor fuels tax section has a large backlog in crosschecking motor fuels dealer reports. Fuel dealers and transporters file monthly reports with the motor fuels tax section. The transporter must provide one (1) duplicate of this report so Revenue can associate it with the appropriate monthly dealer reports. Crosschecking these reports allows Revenue to detect discrepancies in delivery dates and fuel quantities reported. This identifies likely candidates for an audit, making it possible to bill for any additional taxes due.

About 628 dealers filed monthly reports in FY05 for a total of approximately 7,536 reports. The backlog was 26,921 as of June 2005, up slightly from 26,232 in May 2004 but down from 33,000 during the FY03 audit. Some FY05 reports have already been crosschecked because motor fuel section staff members often perform a crosscheck at the same time they make an adjustment to a report. This means that the oldest reports in the backlog are approximately four (4) years old.

Revenue's FY04 corrective action plan called for additional staff to be hired and/or assigned to reduce the backlog. Continued staffing shortages have hindered implementation of this portion of the plan. The corrective action plan also stated that Revenue had begun the initial fact finding for a computerized system, and that a Proposed Capital Project Plan for one had been submitted. COT has not yet approved this project.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 05-REV-8: Motor Fuels Dealer Reports Should Be Crosschecked For Accuracy To Ensure All Taxes Have Been Remitted (Continued)**

Dealer and transporter reports may contain errors or omissions. Discovery of these errors during crosschecking may lead to an audit, resulting in the issuance of tax bills and increased revenue. Failure to crosscheck the reports promptly means that the Commonwealth may not be receiving all taxes timely.

Per KRS 138.230, dealers are required to maintain their records for only five (5) years. Consequently, all dealer and transporter audits must be conducted within five (5) years of filing. The backlog, which grew during FY05, already extends approximately four (4) years. Additional loss of staff as a result of illness, termination, or reassignment could stretch the backlog to five (5) years. The existing delay in crosschecking may result in delayed tax collection; an increase in the backlog would risk making taxes due uncollectible.

Dealers are required to maintain records for five (5) years. KRS 138.230 states:

Every dealer receiving gasoline or special fuel in this state shall keep, and preserve for five (5) years, an accurate record of all receipts and of all production, refining, manufacture, compounding, use, sale, distribution and delivery of gasoline and special fuel, together with invoices, bills of lading and other pertinent records and papers required by the Department of Revenue. Every person purchasing gasoline or special fuel from a dealer for resale shall keep, and preserve for a period of five (5) years, a record of all such gasoline or special fuel so purchased and sold or used, and the amount of tax paid to the dealers as part of the purchase price, together with delivery tickets, invoices, bills of lading and such other records as the department shall require.

In addition, KRS 138.347 states:

- (1) Each licensed gasoline and special fuel dealer shall, in accordance with the department's requirements, keep at his principal place of business in this state a complete record of all such gasoline and special fuel sold by him under gasoline refund invoices provided for in KRS 138.351, which records shall give the date of each such sale, the number of gallons sold, the name of the person to whom sold and the sale price.
- (2) Every person to whom a refund permit has been issued under KRS 138.345 shall, in accordance with the department's requirements, keep at his residence or principal place of business in this state a record of each purchase of gasoline and special fuel from a licensed dealer or the dealer's authorized agent, the number of gallons purchased, the name of the seller, and the date of purchase.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-REV-8: Motor Fuels Dealer Reports Should Be Crosschecked For Accuracy To Ensure All Taxes Have Been Remitted (Continued)

(3) The records required to be kept under subsections (1) and (2) of this section shall at all reasonable hours be subject to inspection by the department or by any person duly authorized by it. Such records shall be preserved and shall not be destroyed until five (5) years after the date the gasoline and special fuel to which they relate was sold and purchased.

In effect, these statutes place a five (5) year limit on conducting audits of motor fuels dealers and transporters.

Good internal controls dictate that motor fuels dealer reports should be crosschecked timely for accuracy. This facilitates monitoring of taxpayer compliance, permits carefully targeted audits, and assures timely and complete tax collection.

Recommendation

Revenue should:

- Expedite plans to institute crosschecking by computer. This would permit prompt reporting and bypass staffing difficulties. Revenue has filed a request with COT for this type of programming. Management should prepare for swift implementation once COT approves the project.
- Provide internal training to teach new employees to crosscheck reports quickly and accurately.
- Reassess staffing levels and assignments in order to shrink the backlog to a reasonable level.

Management's Response and Corrective Action Plan

Revenue concurs with the auditor's findings on the crosschecking of motor fuels tax dealer reports. Despite continued staffing turnover, the Section has stayed the course on inventory levels. Minimal ground was lost from FYE 04 to FYE 05 especially when considering staffing and experience levels during FYE 05. Revenue continues to pursue an electronic processing remedy that encompasses electronic filing and cross-checking of motor fuels tax monthly reports. Revenue is currently gathering information to justify the purchase of a software package to assist in this effort. Revenue staff recently visited and observed a system in operation in a border state. Training efforts for new employees have been accelerated. New employees are targeted at inventory reduction efforts once they are sufficiently trained. Staffing levels are reviewed regularly and adjusted when feasible and resources are available.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-REV-9: The Department Of Revenue Should Consistently Process Local Distribution Journal Vouchers

The Department of Revenue does not consistently process fourth quarter local distribution journal vouchers. Revenue from six (6) tax types [General Property Tax-Real (R251), General Property Tax-Tangible (R252), General Property Tax-Tangible Motor (R253), Public Service Companies Tax (R260), Omitted Tangible Property Tax (R265), and Apportioned Vehicle Property Tax (R266)] is credited to the General Fund upon receipt. Multiple journal vouchers transfer a share of the tax revenue from the General Fund to the Special Deposit Trust Fund each quarter. That tax revenue is then distributed to local governments.

The fourth quarter journal voucher transfers from the General Fund to the Special Deposit Trust Fund occurred before June 30 in 2000, 2001, 2004, and 2005, but after June 30 in 1997, 1998, 1999, 2002, and 2003. The amount transferred for the fourth quarter of FY05 was \$11,538,676.22. In FY02 and FY04, we discussed the inconsistency of processing the fourth quarter local distributions with Revenue. We do understand that payments to local governments for the fourth quarter of the fiscal year typically occur in August, regardless of the timing of the transfer between funds. However, the timing of the transfer should be consistent to accurately report fund receipts and disbursements.

In response to the previous comment issued by this office, the Office of the State Budget Director provided a written response dated May 25, 2005, stating in essence that the handling of journal vouchers will be guided by the fiscal condition of the Commonwealth on June 30 of each year.

We recognize that the Finance & Administration Cabinet and the Office of the State Budget Director have specific statutory duties to properly manage the financial affairs of the Commonwealth; however, the current policy adopted by the Office of the State Budget Director will result in inconsistent financial reporting. Under this policy, a fiscal year could reflect three (3), four (4), or five (5) quarters of receipts in the fund financial statements. The result would be inconsistent financial presentation for analysis and policy purposes.

Generally Accepted Accounting Principles (GAAP) recognizes consistency as an important quality of financial data and reporting. Paragraph 120 of FASB Concept Statement No. 2 states in part that:

Consistency in applying accounting methods over a span of time has always been regarded as an important quality that makes accounting numbers more useful.... The Accounting Principles Board stated in APB Opinion No. 20, *Accounting Changes*, that "... in the preparation of financial statements there is a presumption that an accounting principle once adopted should not

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-REV-9: The Department Of Revenue Should Consistently Process Local Distribution Journal Vouchers (Continued)

be changed in accounting for events and transactions of a similar type. Consistent use of accounting principles from one accounting period to another enhances the utility of financial statements to users by facilitating analysis and understanding of comparative accounting data [paragraph 15].”

The Commonwealth’s financial managers, citizens, and taxpayers will be better served by consistency in financial reporting.

Recommendation

We strongly recommend that the Office of the State Budget Director and the Department of Revenue adopt a consistent policy and apply it.

Management’s Response and Corrective Action Plan

The Department of Revenue, and the Office of State Budget Director, have a statutory obligation to manage the finances of the General Fund in a responsible manner. In years when a projected revenue or budget shortfall is a distinct possibility, it is incumbent upon both parties to take steps to assure that budgeted revenues and expenditures close the fiscal year in balance. Neither statutes nor administrative regulations prescribe a procedure for processing the journal vouchers. It has been the practice to process the journal vouchers for the fourth-quarter property tax distributions in a way to best maintain that balance. This has meant that in some years the processing of the journal vouchers has been postponed until the beginning of the new fiscal year. This in no way impacts the timing of the distribution of affected revenues to local governments. The Department of Revenue and the OSBD have an agreement that stipulates that Revenue will initiate the journal voucher transfers before June 30th unless otherwise directed by OSBD. The OSBD agrees to provide written notification to the Department of Revenue and Auditor of Public Accounts when the timing of journal vouchers is changed in order to maintain budgetary flexibility.

Auditor’s Reply

Management’s response does not constitute a corrective action plan. It is merely a verbatim repetition of the policy critiqued in the RCW. That policy amounts to an agreement to violate GAAP entered into by the state’s senior financial managers. The APA lauds fiscal responsibility, but it recommends that it be exercised by making reasonable estimates of revenues and controlling cash expenditures, not by manipulating the timing of non-cash transfers in violation of GAAP.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-REV-10: The Department Of Revenue Should Ensure The Late Transfers Of Motor Vehicle Usage Tax Are Being Thoroughly Tracked Or Penalized

The Motor Vehicle Usage (MVU) section does not consistently identify all late transfers of daily motor vehicle usage tax collections to Farmers Bank. As a result, the statutory penalty is not consistently assessed and collected. During the audit we examined twenty-five (25) weekly recap reports, fifteen (15) of them after the November 18, 2004 implementation of penalty billing for late transfers. From those fifteen (15) weekly reports, we identified two (2) dates on which either no transfer of tax was made or the transfer amount was insufficient. Only one (1) of those was logged into the spreadsheet for tracking late transfers. No request for a waiver of the penalty was on file, and no penalty was collected in either case.

In one (1) case the deposit amount was \$2,362.63, but only \$1,095.61 was transferred to Farmers Bank. The cause of the shortage was that the clerk transferred the previous day's deposit amount. The remaining \$1,267.02 was transferred after Operations staff informed the clerk of the shortage. It was received two (2) months late, and a late payment penalty of \$1,950 was assessed after the auditor called attention to it. The clerk protested the penalty, saying that Operations staff had waived the penalty because the cause was a clerical error. Fair Oaks staff had no record of that waiver.

In another instance a deposit of \$5,355.85 was not transferred timely. The transfer was made more than three (3) months late after prompting by Operations staff. Because the county was not on that week's audit schedule, Fair Oaks staff did not realize that the transfer was late. A late transfer penalty of \$9,774.70 could have been assessed, but none was issued.

Examination of ten (10) weekly recap reports prior to implementation of penalty billing revealed another problem. Three (3) instances of insufficient transfers were found: a transfer of \$4,949.44 made more than three (3) months after it was due, a transfer of \$13,190.93 made more than three (3) months after it was due, and a transfer that was \$29.10 too small in which the shortage was not made up for more than four (4) months. Follow-up on these revealed that in each case, the clerk had an ACH confirmation number to support the contention that the transfer had, in fact, been done properly and timely. Data from the confirmation numbers can be accessed for only five (5) days after the transfer, so the MVU section cannot verify the transaction details to support the penalty assessment.

The compliance effort involved in tracking the timeliness and completeness of motor vehicle usage tax receipts, deposits, transfers, and recap reports is inherently complex. Receipts, deposits, and transfers take place daily, recap reports are submitted weekly, and the related bank statements arrive monthly. MVU staff deal with 120 county clerks, whose business background, staff size and training, and quantity of receipts handled varies significantly. The staff maintains banking relationships with 120 local banks, Farmers Bank in Frankfort, and the ACH vendor, Metavante. Further complicating matters is the

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-REV-10: The Department Of Revenue Should Ensure The Late Transfers Of Motor Vehicle Usage Tax Are Being Thoroughly Tracked Or Penalized (Continued)

division of MVU staff and records between 200 Fair Oaks and Division of Operations. The auditor evaluated the processing steps involving Division of Operations, Fair Oaks, Farmers Bank, Metavante, County Clerks, the Transportation Cabinet, and local banks. The condition is caused by the weaknesses described below.

1. Dividing MVU staff and records between Fair Oaks and Division of Operations has led to communication gaps. Frequently Operations staff members call clerks about transfers that were omitted or made for the wrong amount. If compliance staff at Fair Oaks had access to this information, they could use it to add the relevant county to the audit schedule. Operations staff may tell the clerk that no penalty will be assessed when the cause of the omitted or incorrect transfer is reasonable, but this information often is not communicated to the proper channels at Fair Oaks.
2. Compliance staff at Fair Oaks need records stored at Division of Operations to track the timeliness of deposits. They currently use deposit tickets, which do not provide a reliable deposit date. County clerk employees prepare and date the deposit tickets, many of which do not confirm the deposit date by the bank's stamp or an attached receipt. Bank statements stored at Division of Operations are the only reliable source of data on the timeliness of deposits, which is tracked at Fair Oaks. While we found no problems with deposit timeliness, the separation of records is a weakness.
3. Duplication of effort and poor communication hinders tracking of transfers. Some tasks performed by MVU staff at Division of Operations identify missing or insufficient transfers. Their work includes matching the amount of the transfer to the ACH report (a week's receipts by county compiled from daily reports from Farmers Bank). A failure to match suggests a problem. The bank reconciliation process includes listing the amounts and dates of any deposits not transferred; any items older than the last two days of the month indicate a late transfer or one for the wrong amount. However, this very useful information is not being transmitted to compliance personnel at Fair Oaks.
4. Some late transfers are not identified because only a portion of recap reports is audited each week. Because of the size of the workload, the counties selected for audits each week are those that have had problems recently and a portion of the rest, rotating through all the counties frequently.
5. Penalties for a late or too small transfer are unenforceable because transfer data can be retrieved from the ACH vendor for only five (5) days. The clerks have typically two weeks in which to complete and send in the recap report. Additional time is needed for processing. By the time the MVU staff examines the recap report, the ACH tracking number is no longer available. If a question arises, no useful information is available from the vendor.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 05-REV-10: The Department Of Revenue Should Ensure The Late Transfers Of Motor Vehicle Usage Tax Are Being Thoroughly Tracked Or Penalized (Continued)**

In relation to the Department of Revenue's motor vehicle usage receipts, KRS 138.464 states:

The clerk shall deposit motor vehicle usage tax collections not later than the next business day following receipt in a Commonwealth of Kentucky, Revenue Cabinet account in a bank designated as a depository for state funds. The clerk may be required to then cause the funds to be transferred from the local depository bank to the State Treasury in whatever manner and at times prescribed by the secretary of the Revenue Cabinet or his designee.... Failure to deposit or, if required, transfer collections as required above shall subject the clerk to a penalty of two and one-half percent (2.5%) of the amount not deposited or, if required, not transferred as required above.

The Department of Revenue Motor Vehicle Usage tax section is responsible for complete and equitable collection of all taxes and penalties. Failure to establish and follow appropriate internal controls risks placing the MVU section out of compliance with KRS 138.464.

Recommendation

The Department of Revenue Motor Vehicle Usage Tax section should store all records at Fair Oaks in order to make complete information available to compliance staff.

The Department of Revenue Motor Vehicle Usage Tax section should take the steps listed below to improve communication between Division of Operations and Fair Oaks.

- Division of Operations MVU staff should flag every recap report on which the deposit amount reported does not match the amount of the ACH transfer.
- Division of Operations MVU staff should flag every bank reconciliation that shows a reconciling item (other than interest) from earlier than the last two days of the month.
- Division of Operations MVU staff should create a log of every recap report and bank reconciliation that has been flagged. They should regularly forward the log to Fair Oaks MVU staff.
- Fair Oaks MVU staff should assign top priority in choosing recap reports for auditing to those that have been flagged.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-REV-10: The Department Of Revenue Should Ensure The Late Transfers Of Motor Vehicle Usage Tax Are Being Thoroughly Tracked Or Penalized (Continued)

Recommendation (Continued)

The Department of Revenue Motor Vehicle Usage Tax section should investigate extending read-only access to the ACH database to all compliance workers at Fair Oaks and processing staff at Division of Operations.

Until such time as the ACH database becomes available electronically, Division of Operations MVU staff should print two (2) copies of each county's weekly ACH report to verify all transfers were made. Attach both applicable ACH reports to every recap report.

The Department of Revenue should negotiate with Farmers Bank about modifying the ACH tracking number system to extend data availability to a minimum of 30 days instead of the existing 5 days.

The Department of Revenue should investigate eliminating the ACH problems by moving to an EFT system for all county clerks.

Management's Response and Corrective Action Plan

The Department of Revenue concurs with the Auditor's findings. Enhanced communication between the Division of Operations and Fair Oaks components has been addressed and will be reviewed periodically. Records maintained at Division of Operations will be made available to Fair Oaks staff upon request. Negotiations with the ACH vendor and the Department will be initiated. Pursuit of an EFT remedy for Motor Vehicle Usage Tax is ongoing.

FINDING 05-REV-11: Motor Fuel Dealer Reports Should Be Processed Properly

During the testing of motor fuel dealer reports, we detected an instance in which the taxpayer omitted the fuel shown on one supporting schedule in calculating the tax due. This report had been reviewed; however, the error was not detected and a bill was not issued. We are aware that a bill for \$7,178.66 has been issued since this error was called attention to by our office. However, this error should have been caught in the review.

We also detected neglect in processing the reports. Mailroom personnel are responsible for writing the license number and period in the "For Dept. Use Only" box. They also compare the amount actually received to the amount due, indicating the payment status by a green circle (for a no-pay report) or a green dash (when the payment matches the amount due) next to the amount due on the report. We observed that no license number was written for one (1) report and there was no green dash or circle present on two (2) reports from a sample of fifty-eight (58) tested.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-REV-11: Motor Fuel Dealer Reports Should Be Processed Properly (Continued)

An apparent oversight by Department of Revenue staff caused both the overlooking of relevant data on the supporting schedule and the omission of processing steps in the mailroom. Failure to examine information from all supporting schedules caused an understatement of tax due. Failure to complete all processing steps increases the risk of errors.

Proper internal controls dictate that a review of a motor fuel dealer report should include determining that all supporting schedule totals are properly carried forward. The mailroom should follow all applicable internal controls. Proper processing in the mailroom facilitates accurate review and data entry.

Recommendation

The Department of Revenue should review the training of both new and continuing employees to assure they are aware of and understand procedures they are to follow to ensure compliance with internal controls.

Management's Response and Corrective Action Plan

The Department agrees with the Auditor's findings concerning schedule verification. The pertinent information was not verified adequately during the review process. Review of procedures verifies that the process in place would have detected the omitted schedule. In response to the Auditor's findings, additional emphasis has been placed on training and procedures. Management in the area will practice additional oversight to assure procedures are followed. When electronic filing of returns is achieved, edits will eliminate these types of mistakes.

FINDING 05-REV-12: The Department Of Revenue Should Maintain Tax Returns In A Manner That Ensures Compliance With Confidentiality And Record Retention Laws And Ensures Accountability To Kentucky Taxpayers

During the Department of Revenue audit, we noted problems related to missing tax returns. Revenue failed to locate two (2) corporate tax returns of twenty-five (25) to be tested. Payments of \$2,500 and \$100 were reported to have accompanied the returns, both extension requests. Records show they were sent to Central Files on the same day; this suggests that a box of files went astray. We also were not able to locate one (1) motor fuels dealer report of seventy-seven (77) requested. According to the system, it was a no-pay return.

When tax returns are missing, we cannot determine if the returns were lost, stolen, destroyed, or ever received. Missing documentation causes us to question the legitimacy of a transaction, particularly when a refund is issued. Tax returns are the most persuasive

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-REV-12: The Department Of Revenue Should Maintain Tax Returns In A Manner That Ensures Compliance With Confidentiality And Record Retention Laws And Ensures Accountability To Kentucky Taxpayers (Continued)

evidence available to support the assertion that refunds are legitimate and that they have been properly recorded and classified within the financial statements.

Failure to make proper use of the filing system compromises Revenue's ability to properly safeguard taxpayer information, as required by KRS 131.081 and 131.185. The benefits of retaining tax records are lost if the documentation cannot be easily located and retrieved.

KRS 131.081 (15) states in part that,

“Taxpayers shall have the right to privacy with regard to the information provided on their Kentucky tax returns and reports, including any attached information or documents...no information pertaining to the returns, reports, or the affairs of a person's business shall be divulged by the cabinet to any person...”

KRS 131.185 states,

“Income tax returns shall be kept for five (5) years; primary accounting records of tax payments, seven (7) years; and records containing all data of motor vehicle registration, three (3) years...”

Revenue should maintain tax returns in a manner that ensures compliance with confidentiality and record retention laws and ensures accountability to Kentucky taxpayers.

Recommendation

Revenue should ensure confidential taxpayer information is protected and preserved as required by statute. Training updates should include both Central Files staff and filing staff from other sections in the same sessions to improve consistency and communication. We recommend that the internal auditor increase testing in this area.

Management's Response and Corrective Action Plan

The Department of Revenue agrees with the audit findings. The Department takes very seriously the responsibility of protecting taxpayer information. Procedures already in place, for the most part are functioning properly as this is the first time in several years that documents from the file room that were requested by the auditor could not be found. Copies of the documents requested were attached to the returns in question. Procedures will be reviewed and training updates will include both Central Files staff and filing staff from other sections in the same sessions to improve consistency and communication.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 05-REV-13: The Department Of Revenue Should Determine The Reason An Unhonored Check Processed Incorrectly And Fix The Problem**

Revenue's Cold Check Processing System does not accurately process amounts greater than \$9,999,999. In FY04 an electronic funds transfer (EFT) for \$20,555,012 was unhonored. We know the MIXERS system processed the entire \$20,555,012 because the amount appeared on the receipt screen and the Revenue Unhonored Check Reports. However, both the Unhonored Check Month End Journal Voucher report and the on-line unhonored check inquiry screen showed \$555,012 as the amount of the unhonored check. The system limitation in the numbers field resulted in MARS and Revenue being out of balance until a corrective journal voucher processed.

In FY05, no unhonored checks greater than \$9,999,999 were recorded. However, the recording process that caused these errors in FY04 has not been corrected; therefore, the potential remains for unhonored checks to be incorrectly recorded in the future.

The corrective action plan in FY04 included a project request for the cold check processing system to be modified to accept amounts greater than \$9,999,999. We are aware that Revenue made a project request in November 2004; however, the problem has not yet been corrected.

Finance uses the Unhonored Check Month End Journal Vouchers Report to enter the cold check JV into MARS. When the report is incorrect, Finance has to do a correcting JV for the difference. In FY04, the Unhonored Check Month End Journal Voucher Report was incorrect due to the system limitation, but Revenue's cold check clearing account was correct. This put MARS out of balance with Revenue's system until the correcting JV was done. If another payment over \$9,999,999 were to be unhonored, Revenue personnel who review the unhonored check clearing account on the computer, would not know the correct amount of the unhonored check, unless they subsequently reviewed the Unhonored Check Report.

Although the Unhonored Check Month End Journal Voucher Report was not affected in FY05, the system limitation could impair the accuracy and reliability of the Revenue reporting system.

Good internal controls dictate that unhonored checks should accurately post to both MARS and Revenue's computer system, regardless of the amount.

Recommendation

We recommend the Department of Revenue carry out their existing corrective action plan so this situation does not recur.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 05-REV-13: The Department Of Revenue Should Determine The Reason An Unhonored Check Processed Incorrectly And Fix The Problem (Continued)****Management's Response and Corrective Action Plan**

The Department of Revenue agrees with the Auditor's findings and has done a project request to have the cold check processing system modified to accept amounts greater than \$9,999,999. Due to limited resources and mandated system changes due to Tax Modernization and Budget legislation, the project has not yet been completed

FINDING 05-REV-14: The Department Of Revenue Should Strengthen Controls With The Compliance And Receivable System

Revenue's Compliance And Receivable System (CARS) allows some entries to be made including money maintenance, without approval. During the course of the audit, a Department of Revenue employee brought to the auditor's attention that if someone were adjusting a bill in CARS and applying a payment at the same time (resulting in a net balance of zero) then the system would not route for an approval. A transaction that creates a zero balance is not considered money maintenance by the system; therefore, no approval is required. The employee was aware of two (2) instances of this situation occurring. This does not appear to be a routine entry; however, there is a risk when this situation is present.

This system weakness could allow concealment of fraud. For instance, an employee could receive a cash payment of the full amount due of \$1,000, credit a payment of \$600, and make an adjustment to the system for \$400 in order to pocket it. Currently, approval is not necessary on this type of transaction. Without requiring approval on all payments and adjustments, no assurance is given that amounts paid and adjusted are complete and accurate.

Good internal controls dictate that approvals be required for all entries that include payments and adjustments, regardless of the net value.

Recommendation

We recommend the Department of Revenue strengthen its controls with the Compliance And Receivable System. An approval should be required for all payments and adjustments, even those that result in a zero balance, to prevent fraud from occurring and being concealed. We also recommend that the Department of Internal Audit look into this.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 05-REV-14: The Department Of Revenue Should Strengthen Controls With The Compliance And Receivable System (Continued)**

Management's Response and Corrective Action Plan

The Department of Revenue agrees with the auditor's recommendations related to Revenue's Compliance And Receivable System (CARS) allowing some entries to be made including money maintenance, without approval. Approval is not required for an adjustment that results in no change to the Overpayment or Total Due amount on the bill. The Department recognizes that this is a problem that needs to be fixed. The Department has submitted a request to COT to have this corrected.

FINDING 05-REV-15: The Department Of Revenue Should Ensure Proper Cash Handling Procedures Are Being Followed

Nine (9) checks totaling \$1,382,672.87 were sent through state messenger mail from the Motor Fuels tax section at 200 Fair Oaks to Division of Operations during the FY05 closeout period. The Department of Revenue's courier staff was not notified to pick up these checks. Auditor requested to review the Receipts Log for these checks and determined that all nine (9) checks were from the same taxpayer and received by the Motor Fuel tax section on 6/27/05; however, they were not routed to Division of Operations until 6/30/05. The security of the checks for those three (3) days is uncertain.

Cash handling procedures were not followed. "Cash" includes coin, currency, checks, money orders, and credit card transactions. The Department of Revenue's cash handling procedures prohibit sending cash through the state's messenger mail. Instead, Revenue's couriers should pick up cash received at Fair Oaks and transport it to Division of Operations. If the cash is received too late in the afternoon, it is to be hand delivered by selected staff. If the selected staff is not available, the checks are to be locked up until the next day. These procedures were not followed.

Information from interviews revealed that tax forms that have been boxed up and sent from Division of Operations to Fair Oaks sometimes contain taxpayer checks between tax forms. The checks must be returned to Division of Operations for deposit. The checks could sit in boxes for an undetermined amount of time without being noticed. Tax forms should be more closely inspected to ensure all checks are pulled and deposited in a timely manner.

Transporting cash through regular messenger mail increases the risk of mishandling of cash, theft or loss. Messengers could leave the cash unattended, store mail in areas that were accessible to several people, or not locked in a secure location.

When checks are not pulled from the tax forms before they leave Division of Operations, a timely deposit cannot be made. Failure to make timely deposits increases the risk of loss due to theft or human error. In addition, the state loses interest income on monies that could have been invested. This also creates year-end problems with financial reporting and revenue recognition.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating to Internal Controls and/or Instances of Noncompliance

FINDING 05-REV-15: The Department Of Revenue Should Ensure Proper Cash Handling Procedures Are Being Followed (Continued)

Good internal controls dictate that physical controls to secure and safeguard cash, checks and other negotiable instruments should be established and in place. Strong internal controls are necessary to prevent mishandling of funds and to safeguard against loss. They also protect employees from inappropriate charges of mishandling of funds by defining responsibilities in the cash handling process.

KRS 41.070 states that receipts should be deposited in the "*most prompt and cost-efficient manner available.*" The state needs complete and prompt deposits of its cash receipts in order to honor its obligations to vendors, creditors, employees, and those who depend on its programs. Proper handling of cash receipts allows maximization of interest income and minimization of interest expense.

Recommendation

We recommend that cash handling procedures be emphasized in all divisions that may receive cash. Management should ensure that all staff are aware of their expectations. Periodically, management should conduct reviews to ensure personnel are adhering to written procedures.

We recommend that the Division of Internal Audit examine the cash handling procedures and perform procedures to ensure they are being followed.

We recommend that the Department of Revenue contact those taxpayers who routinely send their checks to Fair Oaks and request they send the checks to Division of Operations. This will reduce the need to transport cash receipts between offices and ensure a more timely deposit.

We recommend that the staff at Division of Operations more thoroughly review tax forms to ensure all checks are pulled before being boxed up and shipped to other locations.

Management's Response and Corrective Action Plan

The Department of Revenue concurs with the Auditor's findings in regard to cash handling procedures. Cash handling procedures were in place in the Division of Miscellaneous Taxes in accordance with Standard Procedure # 11.11 and would have prevented the event if they had been followed. Employees have been directed to follow the procedures specifically. Management in the area will exert additional oversight in verifying procedures are followed correctly and promptly. The Check Register Log data has been expanded to include a resolution action to further emphasize the need for timely action. Management in the area will contact and direct taxpayers to send payments to Revenue Operations instead of to the taxing

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 05-REV-15: The Department Of Revenue Should Ensure Proper Cash Handling Procedures Are Being Followed (Continued)**

section when applicable. The Division of Operations routinely reinforces the documented cash handling policy with staff and performs spot checks to ensure that procedures are being followed. The Department agrees with the auditor's comments related to remittances being left with returns sent to Central Files and has reinforced the need to review returns thoroughly to identify any remittances with returns and process appropriately.

FINDING 05-REV-16: The Department Of Revenue Should Deposit Unidentified Payments More Timely

Unidentified payments are not being deposited timely. Periodically, payments are received at Division of Operations that cannot be identified or traced to a taxpayer. These payments are most commonly checks or money orders. When the unidentified payment is received, staff at Division of Operations attempts to contact the taxpayer to determine the applicable tax account. If this is unsuccessful, a copy of the payment is sent to the suspected appropriate tax team at Fair Oaks along with any return information and a Revenue Form 21A202 "Instruction Request for Application of Payment", or more commonly known as the "202". The payment itself is placed in the vault until instructions are received as to the disposition of the payment.

Determining the disposition of these payments can be time consuming. The 202 forms and documents can be shifted multiple times from tax team to tax team until they are eventually identified. It can take days, weeks, or longer to identify the applicable tax accounts of these payments. In the meantime, the original source of payment is stored in the vault at Division of Operations. 292 unidentified payments were received in FY 2005. Extended vault storage greatly increases the risk of theft, misplacement, or misappropriation.

Failure to make timely deposits increases the risk of loss due to theft or human error. In addition, the state loses money in interest income on monies that could have been invested if the payments were deposited quickly.

When checks or money orders are not deposited timely, it may create problems at year-end with financial reporting and revenue recognition. Auditor is aware that no unidentified payments were on hand at fiscal year-ending June 30, 2005.

KRS 41.070 states receipts should be deposited in the "most prompt and cost-efficient manner available."

FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 05-REV-16: The Department Of Revenue Should Deposit Unidentified Payments More Timely (Continued)**

Recommendation

We recommend that the Department of Revenue create a new clearing account for depositing all unidentified checks.

The Department of Revenue should consider implementing procedures for submitting these checks to be deposited within three (3) business days.

Management's Response and Corrective Action Plan

The Department of Revenue recognizes the slight increase in risk of theft, misappropriation, and/or misplacement of a remittance when stored for extended periods of time. However, DOR does not agree that establishing a "clearing account" is a cost effective method of depositing these remittances. The additional resources needed to properly post a remittance once it has been identified is routinely three to four times the resources used to post money correctly initially, and, there would be changes needed in many of DOR's processing applications. Additionally, there would be unaccounted for deposits, deposits not posted to the correct receipt account at each month end nor posted to one of DOR's mainframe systems. This would result in understatement of some accounts, and funds, at month end. It should also be noted that the total annual volume of remittances in this category reflect less than .001% of the total remittances processed by Department of Revenue. DOR is currently researching Comprehensive Tax System applications from various vendors working toward a purchase and installation in FY '07. Upon implementation of this new system, the ability to process unidentified receipts in a more timely manner will be greatly enhanced

Auditor's Reply

The APA strongly encourages the Department of Revenue to take this recommendation under further consideration. We do recognize that unidentified payments are a small population of remittances processed by the Department of Revenue. However, we do not agree that the process of holding checks for an undisclosed amount of time is the most effective method. By depositing unidentified checks into a clearing account within three (3) business days, the Department of Revenue will be providing a prompt method of deposits, thus complying with KRS 41.070.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2005

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
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Reportable Conditions

(1) Audit findings that have been fully corrected:

FY 04	04-REV-1	The Department of Revenue Should Ensure All Sales And Use Tax Returns Are Processed Accurately And Reconciled Monthly And All System Changes Are Adequately Tested	N/A	0	Resolved in FY 05.
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(2) Audit findings not corrected or partially corrected:

There were no findings for this section.

(3) Corrective action taken is significantly different from corrective action previously reported:

There were no findings for this section.

(4) Audit finding is no longer valid:

There were no findings for this section.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2005

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
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Material Weaknesses/Noncompliances

(1) Audit findings that have been fully corrected:

There were no findings for this section.

(2) Audit findings not corrected or partially corrected:

There were no findings for this section.

(3) Corrective action taken is significantly different from corrective action previously reported:

There were no findings for this section.

(4) Audit finding is no longer valid:

There were no findings for this section.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2005

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
<u>Other Matters</u>					
<i>(1) Audit findings that have been fully corrected:</i>					
FY 04	04-REV-4	The Department of Revenue Should Ensure Key Information is Correctly Reported	N/A	0	Resolved in FY 05.
FY 04	04-REV-5	Monthly Reconciliations Should Be Performed Timely and Any Reconciling Items Resolved	N/A	0	Resolved in FY 05.
FY 03	03-REV-2	The Kentucky Revenue Cabinet Should Update Its Computer Systems To Remove System Limitations Affecting Accuracy And Reliability Of Reporting	N/A	0	Resolved in FY 05.
<i>(2) Audit findings not corrected or partially corrected:</i>					
FY 04	04-REV-2	Motor Fuels Dealer Reports Should Be Crosschecked For Accuracy To Ensure All Taxes Have Been Remitted	N/A	0	See 05-REV-8.
FY 04	04-REV-3	Computer Systems Should Be Updated To Remove System Limitations	N/A	0	See 05-REV-7.
FY 04	04-REV-6	Motor Vehicle Usage Receipts Should Be Timely Transferred Or Deposited	N/A	0	See 05-REV-10.
FY 04	04-REV-7	The Department Of Revenue Should Consistently Process Local Distribution Journal Vouchers	N/A	0	See 05-REV-9.
FY 04	04-REV-8	The Department Of Revenue Should Determine The Reason An Unhonored Check Processed Incorrectly And Fix The Problem	N/A	0	See 05-REV-13.
FY 03	03-REV-6	The Kentucky Revenue Cabinet Should Develop Computer Applications To Streamline The Crosschecking Of Motor Fuel Dealer Reports	N/A	0	See 05-REV-8.
FY 03	03-REV-11	Motor Vehicle Usage Receipts Should Be Timely And Properly Deposited With The State Treasurer	N/A	0	See 05-REV-10.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2005

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
<u>Other Matters</u>					
<i>(2) Audit findings not corrected or partially corrected (Continued):</i>					
FY 02	02-REV-7	The Kentucky Revenue Cabinet Should Implement A System For Crosschecking Motor Fuels Dealer Reports	N/A	0	See 05-REV-8.
FY 02	02-REV-2	The Kentucky Revenue Cabinet Should Update The Sales Tax Database And Automate Processing Of Accelerated Tax Returns	N/A	0	See 05-REV-4.
FY 01	01-REV-4	The Revenue Cabinet Should Implement A System For Crosschecking Motor Fuels Dealer Reports	N/A	0	See 05-REV-8.
FY 01	01-REV-1	The Revenue Cabinet Should Update The Sales Tax Database And Automate Processing Of Accelerated Tax Returns	N/A	0	See 05-REV-4.
FY 98	98-KRC-3	The Revenue Cabinet Should Ensure That Motor Fuel Reports Are Crosschecked As Required	N/A	0	See 05-REV-8.

(3) Corrective action taken is significantly different from corrective action previously reported:

There were no findings for this section.

(4) Audit finding is no longer valid:

There were no findings for this section.